Economic aspects of the eastern enlargement of the European Union

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Wirtschaftliche Aspekte der EU-Osterweiterung

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Kurzfassung

Vorbemerkung

Die EU will in zwei Runden eine Osterweiterung nach 2001 realisieren, wodurch die Zahl der Mitgliedsländer auf 21 bzw. 26 steigen würde. Für die EU ergibt sich eine Reihe von Anpassungserfordernissen durch jede Art von Osterweiterung, die unmittelbar im Anschluß an die volle Umsetzung der Währungsunion beginnen würde. Während auf die EU-15-Länder durch eine EU-Osterweiterung verstärkte Finanzierungslasten zukommen, können zugleich ökonomische Vorteile einer EU-Erweiterung nicht übersehen werden – zumindest für die lange Sicht. Ein wesentliches politisch-psychologisches Problem einer EU-Osterweiterung liegt darin, daß erhöhte budgetäre Beitragsleistungen wichtiger Mitgliedsländer unmittelbar sichtbar sind, während die "Club-Vorteile" der Erweiterung zumindest für die Altmitglieder nur indirekt sichtbar werden. Am Beispiel von Modellsimulationen für Österreich kann gezeigt werden, daß die Belastungen einer ersten Erweiterungsrunde für Staatshaushalt und Arbeitsmarkt eher gering sind – ja, es sind Nettovorteile zu erwarten. Sehr viel problematischer dürfte ein zweite EU-Osterweiterungsrunde sein, wobei wegen der inhärenten Verknüpfungen der beiden Erweiterungsrunden diese Problematik schon in der ersten Runde dringend zu bedenken wäre. Besonders wichtig wäre eine EU-Verfassungsreform, und zwar inklusive Maßnahmen zur Begrenzung eines relativen politischen Übergewichts der kleineren EU-Mitgliedsländer. Vorschläge zur Reform der EU-Strukturpolitik bzw. der Budget-Prioritäten sind gleichfalls dringlich.

Ergebnisse

1. Eine EU-Osterweiterung schafft erhebliche Anpassungsprobleme für die EU-Struktur- und die EU-Agrarpolitik, da die Beitrittskandidaten mit Ausnahme von Tschechien relativ arm und durch hohe Anteile der Beschäftigung in der Landwirtschaft gekennzeichnet sind.
2. Eine erste EU-Osterweiterungsrunde dürfte zu erheblichen Handelsschaffungseffekten und damit zu mehr Wirtschaftswachstum führen. Die Nettowohlfahrtseffekte für Österreich sind eindeutig positiv, so daß für Deutschland ähnliche Größenordnungen gelten könnten.
3. An den EU-Ostgrenzen sind die Unterschiede im Pro-Kopf-Einkommen größer, als eine Durchschnittsbetrachtung der EU-Osterweiterung erwarten läßt, so daß gravierende regionale Divergenzen – auch als Wanderungsanreize – zu beachten sind.

4. Mit einer EU-Osterweiterungsrunde ergibt sich nicht nur erheblicher wirtschaftspolitischer Reformbedarf bei der EU-Wirtschaftspolitik. Vielmehr entstehen erhebliche verfassungspolitische EU-Probleme, da sich die Machtbalance zwischen reichen und relativ armen Ländern einerseits und zwischen großen und kleinen Ländern andererseits verschiebt. Diese Verschiebungsprobleme der Machtbalance wird mit einer zweiten EU-Osterweiterung außerordentlich gravierend, so daß man die Probleme schon im Vorfeld der ersten Erweiterungsrunde bedenken sollte.

5. Die EU droht nach einer zweifachen Osterweiterung zu einer Gemeinschaft zu werden, in der verstärkt wachstumsfeindliche budgetäre Umverteilungspolitik und von daher verlangsamter beschäftigungsfeindlicher Strukturwandel drohen. Zudem könnte angesichts wachsender ökonomischer Divergenz in einer erweiterten EU die politische Führungs- und Gestaltungskraft der Gemeinschaft geschwächt werden.

6. Bei der EU-Strukturpolitik gibt es relativ einfache Möglichkeiten zu einer Reform, schwieriger ist die Situation in der Agrarpolitik. Um mehr Wachstum und Beschäftigung in der EU zu erreichen, wären neue EU-Budgetprioritäten sinnvoll, insbesondere höhere Ausgaben für Innovationsförderung und zur Stimulierung einer europäischen Informationsgesellschaft.

7. Da die EU-Osterweiterung das ökonomische Gewicht der EU vergrößert, kommt einer erweiterten Gemeinschaft mehr globale Verantwortung zu. Durch eine institutionelle bzw. EU-Verfassungsreform könnten hierzu die Grundlagen verbessert werden.

8. Eine EU-Osterweiterung dürfte Rußland indirekt schwächen, da diesem Land Handelsablenkungseffekte bzw. Wachstumsverluste drohen. Dem könnte durch ein Freihandelsabkommen entgegengewirkt werden. Darüber hinaus sind neue EU-seitige Ansätze zur Stabilisierung Rußlands einerseits und die Schaffung neuer beitrittspolitischer Optionen – unterhalb einer EU-Mitgliedschaft – andererseits erwägenswert, wenn Stabilität und Wohlstand für ganz Europa gesichert werden sollen.

9. Das EU-Modell der sozialen Marktwirtschaft hat, nachdem Reformen in der Wirtschafts- und Tarifpolitik durchgeführt worden sind, durchaus gute Chancen, im globalen Systemwettbewerb mit dem US-Modell zu bestehen. Nach der Asienkrise haben sich jedenfalls die Aussichten verbessert, daß Wirtschaftsordnungen europäischen Typs mit ihrer Doppelbetonung von Effizienz und sozialem Ausgleich international als attraktives Modell erscheinen.

1. Eastern Enlargement as a Community Challenge

The EU has decided to conduct negotiations on eastern enlargement which would consist of two enlargement rounds, each comprised of five eastern European post-socialist economies. A first round started in 1998 and could be completed around 2002 and will also include Cyprus. After the Southern EU enlargement in the 1980s and the EFTAN enlargement round of the 1990s the Community thus has envisaged another major round of EU-widening. For various reasons the eastern EU enlargement of the EU seems to be a very complex topic which involves many economic issues. An eastern EU enlargement clearly is a historical challenge, both for western Europe and for the ex-CMEA area.

A major challenge will be the integration of post-socialist transforming economies, namely countries whose economic system has changed to a market economy only recently so that there are young institutions, while economic behavior is not firmly rooted in market traditions. Since the prospective newcomer countries are also relatively poor one may anticipate that their natural interest is in favor of expanding the EU transfers via higher structural funds expenditures. Obviously, this would be neither conducive to sustained economic growth in the EU and the euro area, respectively; nor be in the interest of the main net contributors of the EU, namely the Netherlands, Germany, Sweden and Austria which in 1997 recorded per capita net contributions of euro 150, 140, 130 and 95, respectively; another net contributor was the UK with euro 33; disregarding the special case of the top recipient Luxembourg with its many EU institutions the main recipients were Ireland (euro 750), Greece (410), Portugal (290) and Spain (150) in 1987. The Netherlands and Germany were top net contributors with 0.7% of the respective GDP in 1997, and these countries clearly are rather unwilling to accept much higher contributions for the sake of EU enlargement. Moreover, the main net recipient countries which cannot expect to reap major benefits from an eastern EU enlargement in the medium term will be unwilling to accept strong cuts in transfers. At the same time there is no doubt that the EU-15 club will have to face major reforms in key policy fields if an eastern enlargement is to become feasible – with agricultural reforms and innovations in the field of regional policy being key areas which promise to be conflict-prone in western Europe.

The reform proposals addressed at the Community itself aim at maintaining a maximum ratio of 1.27% of EU gross domestic product which can be spent at the supranational level. Since in the EU-15 community about 50% of expenditures is for agricultural subsidies and another third for structural funds accruing mainly (2/3) to regions with a per capita income of less than 75% of average EU per capita income ("objective 1 regions") and to regions with declining industrial employment ("objective 2 regions") any eastern EU enlargement entails the risk of strongly rising community expenditures. Post-socialist eastern European countries are poor; the share of agricultural employment and value-added is relatively high, and industrial employment in many regions is falling.

While EU-enlargement raises budgetary risks for the EU-15 this group can expect economic benefits from rising trade and investment – with individual countries gaining the more, the higher the respective share of east European trade.

EU countries differ with respect to trade intensities vis-à-vis eastern Europe. The highest share of CEEC-10 merchandise exports was 9.2% for Austria in 1996, followed by Germany with 6.6% – with each country roughly tripling its share in the seven years after 1989. The CEEC share in German and Austrian imports reached about 6% in 1997 while other countries have much lower shares.

A major challenge of eastern enlargement concerns the increasing economic divergence faced by the Community. Ignoring the outlier country Luxembourg the per capita income figures at purchasing power standards – with the EU average being 100 – were in the range of 67 (Greece) to 116 (Denmark) in 1995, but with a first round of an eastern enlargement the disparity would rise to 31 (Poland) to 116; we have ignored here the even lower and rather insignificant case of the small country Estonia with its 1.5 million inhabitants. Since political preferences are the less homogeneous the greater differentials in per capita income are across countries, sustainable enlargement requires speeding up economic convergence.

A quick, purely market-driven economic convergence process is rather unlikely, but one should not rule out a successful medium-term convergence under certain conditions referring to domestic policies in accession countries and to adequate supranational EU cohesion policy. As regards income differentials one also has to take into account that at the central European border line of the EU-15 group the income differentials are higher than the average European east-west income gap since Germany and Austria stood for income levels of 110 and 112, respectively.

The following analysis will focus on the starting conditions for enlargement in the EU as well as in CEEC-10 in sections 2 and 3. The institutional challenges are discussed in section 4, while section 5 is devoted to the theory of integration and its application – and model simulations – to the issue of an eastern enlargement. Section 6 deals with policy options for sustainable enlargement. At the bottom line we find that economic theory suggests major economic benefits for both the accession countries and the old EU-15 community, but there are serious risks which come with enlargement with respect to the efficiency of future supranational decision-making; and there are the unsolved questions whether or not the increasing economic divergence within the ex-CMEA area will lead to conflicts.

2. The Community Facing the Start of the Euro

The single market dynamics are fully at work in the late 1990s and in combination with ongoing economic globalization (OECD, 1997; Welfens, 1999) and a sharper international innovation race (Welfens/Audretsch/Addison/Grupp, 1998) are fueling an economic upswing in the prelude to the start of the euro. Monetary union will reinforce market transparency and reduce EU internal transaction costs so that competition will intensify further.

Due to the convergence pressure associated with the euro project, most EU countries have achieved considerable progress with respect to key macroeconomic variables including low inflation rates and budget deficit-GDP ratios below the critical 3% ceiling in 1997/98. Many countries still are above the 60% limit for the debt-GDP ratio, but most countries face favorable medium-term prospects to converge towards this ratio provided no adverse shocks hit the EU and euro-land, respectively. The elimination of EU internal exchange rate volatility and the switch to reduced money supply volatility in the relatively large monetary union lets one expect higher investment-GDP ratios in the euro area (Jungmittag/Welfens, 1998). This positive growth effect normally should dominate the negative welfare effect which is associated with the loss of the exchange rate instrument in the monetary union. However, the question has to be raised which group of countries can easily forego the option of a nominal revaluation or devaluation – we will see later that large per capita income differentials among countries in a monetary union pose a case against monetary union.

With 11 countries starting the euro and the European Central Bank in 1999 there is a new monetary regime in Western Europe, namely a centralized politically independent EU central bank with the goal of price stability. Since the exchange rate policy instrument is no longer available within euro-land there could be major problems in the presence of asymmetric economic shocks – at least as long as labor mobility in euro-land is low and wage rigidity widespread. While EMU has large potential economic benefits (Welfens, 1997; Welfens, 1998; Kenen, 1998) it is unclear whether intensified locational competition within euro-land, more integrated financial markets and accentuated competition will bring about required reforms in the social security system, in labor markets and in government.

With the start of monetary union in 1999 the *acquis communautaire* (the set of relevant rules) is broadened in comparison to earlier enlargement rounds, e.g. the southern enlargement in the 1980s and the EFTA enlargement in the 1990s. This partly explains why the Community has decided to engage in technical and financial support measures for potential accession countries. While not all EU countries have to be members of monetary union they are required to introduce political independence of the central bank, multilateral surveillance in the field of convergence indicators and application of the stability and growth pact which basically stipulates that the deficit-GDP ratio should not exceed 3% except in cases of an extreme economic downswing or special adverse shocks. Given the enormous needs of transforming countries to invest in infrastructure, the 3% deficit ceiling implicitly restricts public investment to the extent that one can consider loan financing of investment as a natural strategy to share investment costs between present and future generations. A solution to the problem could be to increasingly rely on private financing and operation of certain infrastructures, e.g. toll highways, private airports and privatized telecommunication networks (EBRD, 1996; Welfens et al., 1998).

Given the double problem of high EU unemployment and unsustainable social security systems facing the problems of a graying society, reforms of the public sector would have to reduce labor costs and reduce the fear of ever increasing social security contributions and tax rates which all impair regaining full employment. High unemployment rates create political reservations against labor mobility and enlargement in EU countries. Partly replacing social security systems with voluntary private savings – in favor of new pension funds and life insurance schemes – is politically extremely difficult in Western Europe. As regards Poland and Hungary one should mention that these two transforming economies already have taken steps to replace the traditional pay-as-you-go system of social security with a capital funded pension system.

3. Eastern Europe After the First Transition Stages

Privatization of the economy, macroeconomic stabilization, economic opening-up and institutional changes in the sphere of labor and capital markets as well as in economic policy were the main steps in the transition process which had largely been completed in Estonia, Poland, Slovenia, Hungary and the Czech Republic by 1998; other transforming countries lag behind for various reasons. Competition policy and R&D policy are crucial for transformation and growth (Ordover/Pittman/ Clyde, 1994; Slay, 1995; Fingleton/Fox/Neven/Seabright, 1996; Radosevic, 1995). It has been adopted in all post-socialist countries, although no transition country, except for Hungary, has an independent, credible anti-trust authority. Efficient corporate governance also is a crucial problem which is related to the mode of privatization chosen, the rules for the capital market and the most common incentive schemes for managers (Welfens, 1992; Jasinski/Welfens, 1994; Valbonesi, 1995).

Facing declining internal demand and the switch to the new market conditions many transforming economies recorded problems with the banking system which faced a high share – 20-40% at some period – of non-performing loans. Concerns about financial market stability have increased in the wake of the Asian financial market crisis but also because one of the four freedoms of the single market calls for free capital movements – those could be easily destabilizing in a situation of adverse shocks hitting an unsound banking system. In the Czech Republic the share of non-performing loans in total loans declined gradually after 1994 (BIS, 1998, p. 53); it fell more swiftly in Hungary and Poland. However, other CEECs, above all Bulgaria and Romania, have not yet sorted out financial market problems.

In the period 1989-97 post-socialist transformation countries achieved considerable progress in the transition towards a market economy although one cannot overlook major divergences between the various ex-CMEA countries (see Table 1). Even within the Visegrad (starter) countries there are problems as became evident by the Czech currency crisis in 1997. This crisis is mainly related to lack of efficient corporate governance and a weak banking system which in turn have slowed down the pace of structural change which is one of the keys to sustained economic growth in the transition stage. Indeed, the transformation process in the former GDR clearly shows the important links between structural change, economic growth and factor rewards (Heilemann/Löbbe, 1996).

Table 1:
Applicant Countries of Central and Eastern Europe and EU Member States (Basic Data 1995)

	Area (1000m^2)	Population (millions)	Density (inch/km^2)	GDP at Current Prices (billion ECU)	GDP at Current Prices (ECU/head percentages of EU average)	GDP. Purchasing Power (ECU/head percentages of EU average)	Agriculture % of employment
Hungary	93	10.2	110	33.4	19	37	8
Poland	313	38.6	123	90.2	14	31	26.9
Romania	238	22.7	95	27.3	7	23	34.4
Slovak Rep	49	5.4	110	13.3	14	41	9.7
Lativa	65	2.5	38	3.4	8	18	18.5
Estonia	45	1.5	33	2.8	11	23	13.1
Lithuania	65	3.7	57	3.5	5	24	23.8
Bulgaria	111	8.4	76	9.9	7	24	23.2
Czech Republic	79	10.3	130	36.1	20	55	6.3
Slovenia	20	2	100	14.2	42	59	7.1
CE 10	1078	105.3	98	234	13	32	22.5
in % of EU 15	33	28	85	4			425

Continuation of Table 1:

Belgium	31	10.1	332	205.9	118	112	2.7
Denmark	43	5.2	1221	132.1	146	116	4.4
Germany	357	81.5	228	1845.2	131	110	3.2
Greece	132	10.4	79	87.4	48	66	20.4
Spain	506	39.2	77	428.1	63	77	9.3
France	544	58	107	1174.3	117	107	4.9
Ireland	70	3.6	51	49.2	80	93	12
Italy	301	57.3	190	831.4	83	103	7.5
Luxembourg	3	0.4	157	13.3	187	169	3.9
Netherlands	42	15.4	371	302.5	113	107	3.8
Austria	84	8.9	96	178.4	128	112	7.3
Portugal	92	9.9	108	77.1	45	67	11.5
Finland	338	5.1	15	95.6	108	96	7.8
Sweden	450	8.8	20	176.3	116	101	3.3
United Kingdom	244	58.5	240	844.8	83	96	2.1
EU 15	3236	371.6	115	6441.5	100	100	5.3

Source: CEECs Statistical Yearbooks, Eurostat.

Structural change in the course of systemic transition and economic opening-up will show up in the form of a high rate of intersectoral reallocation of labor so that the standard deviation of sectoral employment growth rates – measured across sectors – should be rather high (see Table 2). Boeri (1997) distinguished nine sectors and defines an expansion/contraction reallocation index and a reallocation/privatization index covering job flows from the state sector – including state-owned firms – to the private sector; a rising index indicates a higher speed of reallocation. The degree of structural change in the Czech Republic, Hungary, Poland and the Slovak Republic was much higher than in Bulgaria and Romania which lagged behind both in the process of privatization, in setting up functional capital markets and in opening up the economy. Poland and Hungary showed an increasing degree of structural change in the period 1993-95 as compared to 1991-93, and both countries showed a rising intersectoral employment reallocation which should facilitate productivity gains and real income growth. Poland indeed recorded high growth rates in the 1990s; Hungary's growth resumed after a temporary balance of payments crisis in the mid-1990s.

Disregarding employment reallocation related to privatization one finds, however, a decline in employment dynamics and structural adjustment in the Czech Republic and in the Slovak Republic – partly reflecting corporate governance problems and the lack of strategic investors, respectively. The slowdown of economic growth in the former Czech Republic and the Czech balance of payments crisis in 1996/97 therefore are not surprising. The favorable indicator for the job flow/unemployment rate ratio for the Czech Republic is biased by the fact that the lack of bankruptcies and structural adjustment, respectively, kept the unemployment rate at an artificially low level.

Table 2:
Structural Change & Job Reallocation in Selected Countries (1991-95)

Country		Standard Deviation of Growth Rates	Intersectoral Change[a)]	Intensity of Privatization[b)]	Labor Market Dynamics	Change in Labor Productivity 96/92
Poland	1991-3	13.4	0.49	0.73	2.5	+++
	1993-5	11.1	0.74	0.70	3.0	
Hungary	1991-3	9.3	0.25	0.66	2.4	+++
	1993-5	7.0	0.53	0.88	2.6	
Czech Rep.	1991-3	21.0	0.77	0.78	14.9	++
	1993-5	6.7	0.44	0.64	9.5	
Slovak Rep.	1991-3	24.0	0.70	0.60	3.9	+
	1993-5	7.0	0.38	0.88	2.6	
Bulgaria	1991-3	13.5	0.36	0.68	1.9	+
	1993-5	10.4	0.90	0.64	3.6	
OECD*	1990-3	3.1	0.33	0.09	5.2	+

* Without east European member countries.

Definition:

a) $= 1 - \dfrac{|\Delta E|}{\Delta E^{+} + |\Delta E^{-}|}$ b) $= 1- \dfrac{|\Delta E|}{|\Delta E^{PUB}| + |\Delta E^{PRIV}|}$

where ΔE^{+} is the sum of sectoral job variations in expanding sectors (proxy for gross employment creation) and ΔE the respective figure in declining sectors.

Note:
The sectoral reallocation index is based on gross employment changes across nine sectors. The privatization reallocation index is based on the flow dynamics of job outflows from the state sector and job inflows into the private business sector. Labor market dynamics is measured as monthly inflow into new jobs relative to the unemployment rate (at the beginning of the period).

Source: Boeri (1997), Podkaminer (1997), and UNECE (1997).

As regards key macroeconomic figures Romania, Bulgaria and Russia showed a much worse picture than the countries from the CEEC-5 group in the 1990s. While there is some risk that the first wave of an eastern enlargement transitorily will accentuate the income differentials within eastern Europe, one may anticipate that macroeconomic stabilization and institutional adjustment in the second group of accession countries will favorably be influenced by prospective EU membership. Prospects of EU membership provide adequate incentives, and EU technical support within the novel accession partnership should also facilitate the adjustment process. A more difficult problem is economic and political geography. The second group of accession countries is strongly exposed to potentially destabilizing impulses from Russia which has – much in contrast to the US or Canada and, more importantly, the early reformer China – been characterized by a legacy of declining structural change and increasing overspecialization in the 1980s (see Table 3) plus inconsistent transformation policies in the 1990s.

Table 3:
Industrial Specialization and Structural Change in Canada, the USA, China, and the USSR (1980 and 1990)

1980				
	Canada	USA	China	USSR
Intensity of Structural Change	3.4	2.9	2.4	1.8
Degree of Specialization	10.3	11.9	14.0	18.3
1990				
	Canada	USA	China	USSR
Intensity of Structural Change	3.7	3.3	3.3	0.8
Absolute Change 1990/80	0.3	0.4	0.9	-1.0
Degree of Specialization	11.8	12.3	10.8	19.7
Absolute Change 1990/80	1.5	0.4	-3.2	1.4

Calculations:

Intensity of Structural Change: Moving average (five years, in degree):
$\cos\beta = [\Sigma s^{it} s^{i(t-1)}]/[(\Sigma s^{it})^2 (\Sigma s^{i(t-1)})^2]$

Degree of Specialization: $h = 100\,[1+(\Sigma s^i \ln s^i)/ h^{MAX}]$;
$h^{MAX} = \ln(\text{number of the i sectors})$;
s^i = *share of i in value added;*
indicator h lies in the interval [0,100]

Source: UNIDO and own calculations.

Catching up with the EU will require high sustained economic growth which will be only feasible if accession countries record high investment-GDP ratios, pursue outward-oriented economic policies which support trade and foreign direct investment and if human capital formation – including R&D – are strongly promoted, while levels of foreign and domestic indebtedness of government are kept at manageable levels. As a mathematical exercise one can calculate (Richter, 1998) that accession countries would need the following average annual growth rates to achieve 75% of EU per capita income at purchasing power standards in 2015: Czech Republic and Slovenia 3.4%, Slovak Republic 5.2%, Hungary 6.1%, Poland 6.9%, Romania 9.2% and Bulgaria 10.1%. Such figures are obviously unrealistic although Poland came close to 7% growth in 1996/97. Even for the CEEC-5 group in a first round of eastern enlargement it therefore holds that many if not most regions would qualify as objective 1 regions which are characterized by a nominal income level of less than 75% of the EU average.

4. Agenda 2000 and Institutional Challenges for Accession Countries

The Agenda 2000 emphasizes that the challenges of an eastern enlargement can be coped with on the basis of reinforcing the pre-accession strategy – comprised of the Europe Agreements, the structured policy dialogue and PHARE – with two new elements: support for adopting the Community *acquis* via a single framework for all the resources and forms of assistance available ("Accession Partnership") and extending the participation of applicant countries to EU programs and mechanisms to apply the *acquis*. The Phare program will have two priorities, namely financial support for institution-building and financing of investment projects. There will also be pre-accession aid for agriculture and structural assistance at the regional level. The Accession Partnership will involve (European Commission, 1997, A-8)

> precise commitments on the part of the applicant country, relating in particular to democracy, macro-economic stabilization, nuclear safety and a national program for adopting the Community *acquis* within a precise timetable, focusing on the priority areas identified in each opinion; (and) mobilization of all the resources available in the Community for preparing the applicant countries for accession.

It is unclear from this statement whether a prime requirement for accession indeed is to introduce and maintain democracy within the rule of law. The *acquis* itself consists of specific rules, above all in competition policy, trade policy, regional policy and monetary policy.

The Commission expects in its impact study – being part of Agenda 2000 – that extending Common Agricultural Policies (CAP) will cost some ECU 11 billion per year – an estimate which seems to be rather optimistic if compared to the range proposed by Tangermann (1997); the EU-15 budget in 1997 was ECU 88 billion. No major problems are anticipated in horizontal policies (social policies, environment, consumer, science, R&D, information society, culture-education-training-youth). With respect to sectoral policies the Commission also expects limited problems. The greatest problems will result from the increasing heterogeneity in terms of per capita income in an enlarged EU and the fall of average income (see Table 4) so that structural policy becomes quite important.

Table 4a:
Impact of Successive Enlargements of the EU

(Based on 1995 Data)	*Increase in Area*	*Increase in Population*	*Increase in Total GDP*	*Change in Per Capita GDP*	*Average Per Capita GDP (EUR 6 = 100)*
EUR 9/EUR 6	31%	32%	29%	-3%	97
EUR 12/EUR 9	48%	22%	15%	-6%	91
EUR 15/EUR 12[1]	43%	11%	8%	-3%	89
EUR 26/EUR 15	34%	29%	9%	-16%	75

[1] Including German Unification.

Source: European Commission (1997), Agenda 2000, p. 22.

Table 4b:
Changes in the Population Eligible for Assistance Under the Structural Funds

(Based on 1995 Population Figures)	Eligible Population (in thousands)	Eligible Population as % (EU = 100)	Objective 1 Population (in thousands)	Objective 1 Population as % (EU = 100)
EUR 12 1989	140 600	43.3	69 700	21.4
EUR 15 1995	185 600	49.8	94 000	25.2
EUR 26 2000+	291 400	60.9	199 800	41.7

Source: European Commission (1997), Agenda 2000, p. 25.

Estimating the overall per capita GDP (at purchasing power standards) of the ten CEECs at about 1/3 of the EU-15 average the potential accession countries lie much behind the weakest four EU-15 countries, Greece, Portugal, Spain and Ireland which together reached 74% of the Community average. Within the group of accession candidates – each with considerable internal regional divergences – the range is from 18% (Latvia) to 59% (Slovenia); in 1997 the poorest EU-15 country was Greece with a level of 2/3 of the EU average. The cohesion policies in the enlarged EU would lead to sharply rising expenditures since the population eligible for assistance under objective 1 would rise from 94 to 200 million, and if the other objective criteria for regional policies were not changed, about 60% of the overall EU population would be covered which is inconsistent with the principle of special support for the most disadvantaged regions.

There are urgent reform needs with respect to EU structural policies; an additional constraint proposed by the Commission is that financial funds devoted to cohesion efforts will be raised from 0.41% to a freezed 0.46% of Community GDP. Moreover, the Commission has proposed to maintain objective 1 regions while objective 2 and other objective regions should be merged in a "New Objective 2" definition; another horizontal objective 3 should be created which would focus mainly on supporting economic and social development, lifelong learning and training and active labor market policy. Creating a new objective 3 area is rather doubtful if it is not clear to which extent this promotes economic cohesion in a consistent way doing justice to the principle of subsidiarity at the same time.

While on the one hand one may criticize EU structural funds which for the main recipient countries amounted to 1.4%, 2.6%, 2.7% and 2.8% of GDP (Spain, Ireland, Portugal, and Greece, respectively) in 1996/97, one could, on the other hand, point out that they reflect supranational political leadership and indeed have been successful in promoting the economic catching-up process – except for the case of Greece. The US Marshall plan – including GARIOA funds – clearly was more generous than the envisaged financial support for accession countries and poor regions in the EU-15 group which together will not obtain more than 0.5% of Community GDP as transfers; the US transferred about 1% of its GDP which was equivalent to funds for the recipient countries in the range of 2.4% as in the case of the UK to 14% in Austria (Van Brabant, 1990, p. 108). The EU as a rather synthetical regional superpower obviously finds it more difficult than the US to invest in a transition process which should lead to growing trade between the EU and eastern Europe. Part of the reluctance of EU taxpayers to finance additional transfers to eastern accession countries can be explained by already high marginal tax and social security contributions in the EU where all countries except the UK have relatively high overall tax rates.

5. Theory of Economic Integration and Application to Enlargement

Following neoclassical trade theory one may expect major benefits for eastern European economies from opening-up and the switch to relatively free trade. The export-GDP ratio of Visegrad countries has increased and reached 26% in Poland, 33% in Hungary, 49% in Slovenia, 60% in the Czech Republic and 66% in the Slovac Republic in 1996; Bulgaria and Romania reached 32% and 30% respectively (IMF, 1997). An increase in economic efficiency stimulates economic growth and a rise of consumer welfare due to a higher level of consumption. Modern trade theory additionally suggests benefits from a larger variety of goods available and from easier exploitation of static and dynamic scale economies. Integration theory suggests that creating a larger integration area will bring about trade creating effects raising output and welfare, but also trade diverting effects which impose negative welfare effects for the integration area and former supplier firms from outsider countries. While standard neoclassical trade theory implies international factor price convergence and convergence of per capita income in a world without capital mobility, reality looks different. The more recent new trade and new growth theory has emphasized the role of R&D – with international spillovers – and of economies of scale as well as path-dependent economic development so that imperfect competition results in outcomes which are not compatible with the neoclassical model; indeed all these elements play a role both for Asian NICs and for east European transforming economies (Welfens/Wolf, 1997).

Selected theoretical issues. Economic opening-up and integration should contribute via trade and FDI (Howell, 1995; EBRD 1997; Stern, 1997) to high economic growth in eastern Europe in the first transition stage so that distributional conflicts become less important and further transition steps towards a market economy feasible. With rising per capita income in eastern Europe east-west trade in Europe could be increasingly of the intra-industry type and less interindustrial which is conflict prone for structural adjustment. The share of EU-15 in the CEEC's trade increased markedly in the period 1989-1997 (See Table 5). FDI inflows were unevenly distributed where Hungary and the Czech Republic recorded high cumulative inflows (Table 6).

Table 5:
Share of the EU(15)[1] in the Eastern EU Applicant Countries' Total Trade in Percent
(Based on Customs Statistics)

		1989	1993	1997
Bulgaria[2]	Exports	6.0	30.0	43.3
	Imports	12.5	32.8	37.3
Czech Republic[3]	Exports	31.9	49.4	59.9
	Imports	31.8	52.3	61.7
Estonia[4]	Exports			48.7
	Imports			59.2
Hungary	Exports	33.6	58.1	71.2
	Imports	39.7	54.4	62.6
Poland	Exports	39.6	69.2	64.0
	Imports	42.2	64.7	63.8
Romania	Exports	27.6	41.4	
	Imports	6.5		45.3
Slovakia[5]	Exports	32.2	29.5	45.0
	Imports	34.4	27.9	39.5
Slovenia[6]	Exports	58.0	63.2	63.6
	Imports	66.9	65.6	67.4

1) Austria, Finland and Sweden are included in the 1989-1994 data. 2) In 1992 methodological changes took effect; imports are FOB up to 1991 and CIF since 1992. 3) In 1993 and thereafter total trade figures include Slovakia. 4) In 1994 EU(9). 5) In 1993 and thereafter total trade figures include the Czech Republic. 6) In 1992 and thereafter total trade figures include ex-Yugoslavia.

Source: WIIW Database incorporating national statistics.

Table 6:
Indicators of Foreign Direct Investment[A] in East European, Baltic and European CIS Countries (1995-1997)

	FDI Net Flow / GDP (%)			Cumulative Inflow (mill. $)		Cumulative Inflow Per Capita ($)	
	1995	1996	1997	1996	1997	1996	1997
Eastern Europe	2.8	2.2	2.4	30670	39320	276	354
Albania[C]	2.9	4.5	2.0	291	339	86	97
Bulgaria	0.7	1.4	4.4	446	884	53	105
Croatia[C]	0.4	2.6	1.8	830	1164	184	259
Czech Republic	5	2.5	4	7282	8582	710	838
Hungary	9.9	4.4	3.7	13377	15462	1331	1548
Poland[C]	1	2	2.2	5492	8526	142	221
Romania	1.2	0.7	2.7	1237	2193	55	97
Slovakia	0.9	1.1	0.4	886	1026	166	192
Slovenia	0.9	0.9	1.6	785	1100	408	572
The Former Yugoslav Republic of Macedonia[C]	0.2	0.3	0.2	44	52	20	24
Baltic States	3.7	3.7	5	1959	3031	284	396
Estonia	5.6	2.5	4.5	799	1106	602	760
Latvia	5.5	7.5	7.3	864	1284	371	519
Lithuania	1.9	1.2	3.8	296	641	101	172
European CIS	0.5	0.5	0.9	9669	17117	45	80
Belarus[A]	0.1	0.5	1.2	111	273	11	26
Republic of Moldova	4.5	2.7	2.3	152	195	34	44
Russian Federation	0.5	0.5	0.9	8092	14789	55	100
Ukraine	0.7	1.2	0.9	1345	1861	26	36
Total Above	1.6	1.3	1.6	42329	59468	127	179

A) Cash basis.

B) Estimates of FDI by extrapolating partial year rates to the entire year (except for the Czech Republic and Hungary for which full year data were available). January-November rates were used for Poland, Slovakia and Slovenia; January-September rates were applied for all other countries except Romania, which are official estimates.

C) In reporting country except for Albania, Poland and the former Republic of Macedonia for which data are net of residents abroad.

Source: UNECE (1998), p. 63.

From a theoretical perspective an economic opening-up in eastern Europe and EU enlargement should bring about five main growth-related effects for accession countries whereby the first three refer to traditional arguments in textbook literature and recent extensions in modern trade theory (Baldwin, 1992; Baldwin/Seghezza, 1996):

- efficiency gains due to increased import competition in eastern Europe;
- economies of scale effects related to EU market access;
- gains from specialization and a rise in the range of product varieties which allow realization of a higher level of consumption and utility, respectively;
- growth effects related to imports of intermediate products and technology-intensive machinery and equipment where positive spillover effects could occur. Coe/Helpman (1993) found – in a study for OECD countries – a significant impact of trade-weighted cumulated R&D stocks of trading partners; hence, provided that consumption goods are not dominant on the import side one may emphasize the crucial role of rising imports for growth and transition, respectively;
- increasing EU foreign direct investment flows to eastern Europe, in particular in the case of an EU eastern enlargement which effectively eliminates political risk from the perspective of an EU investor. With respect to eastern Europe there will be FDI diversion as US would-be investors might be crowded out by EU firms which enjoy particular advantages in investing in an enlarged home market. At the same time the overall fall in the implicit risk premium for eastern Europe will cause FDI creation so that the steady state FDI flows and the respective FDI stock/GDP ratio should increase (Welfens, 1994). The long-run increase in capital intensity should – in line with traditional analysis – lead to higher labor productivity and hence rising real wages in eastern Europe.

In the spirit of the neoclassical trade theory one may also analyze trade-induced changes in specialization and in relative factor rewards. For the most active EU exporters to eastern Europe one typically finds that factor content of exports is mainly capital and skilled labor so that removal of trade barriers and EU enlargement, respectively, suggest that in a situation of rising EU net exports the demand for skilled labor will increase in Western Europe leading to a rising wage differential between skilled and unskilled labor. This conclusion for which Smith (1997) provided empirical evidence is, however, not valid for all countries, and the paradox case of a declining wage dispersion will subsequently indeed be explained for the case of Austria.

The first attempts to quantify the effects of EU enlargement used gravity models of trade and computable general equilibrium models (e.g. Winters/Wang, 1994; Holzmann/Zukowska-Gagelmann, 1997; Gasiorek/Smith/Venables, 1994; Ambrus-Lakatos/Schaffer, 1996); more recently gravity models for foreign direct investment (Döhrn, 1996) have also been used.

Gravity models emphasize the role of economic growth and geographic distance in explaining trade and foreign direct investment (FDI), respectively.

Advanced computable general equilibrium models suggest considerable economic benefits from an eastern EU enlargement – for the case of Austria see Keuschnigg/Kohler (1998) who find within a computable general equilibrium model positive growth, employment and revenue effects for Austria. There are, however, some issues to be raised in the context of a critique of the model setup or – put differently – in the context of potential extensions of the model:

- How will the introduction of FDI into the trade-dominant traditional models affect the cost-benefit issue for eastern Europe? While there is little doubt that FDI stimulates technology transfer and thus contributes to higher growth there are obviously political reservations against high FDI inflows in some CEECs, especially with respect to German investment which raises historical fears of dominance. Moreover, asymmetric international property rights certainly will impair the convergence of real per capita GNPs and thus undermine the neoclassical convergence message from neoclassical textbook models which ignore FDI and the necessary distinction between GNP and GDP. An illustrative asymmetric two country model with identical production functions Y=Kexpß Lexp(1-ß) and identical stocks of labor L and capital K in country I and II, respectively, will result in equal GDPs (Y in country I, which is the source country of FDI, Y* abroad – in country II), while per capita GNPs (y and y*) will strongly differ in the illustrative case that country I owns the capital stock of both countries (Welfens, 1994, 1997); the source country of FDI will record a GNP = Y + ßY* while country II will record a GNP = Y*(1–ß); the ratio of per capita GNPs will be Y(1+ß)/(Y(1-ß)) = 2:1 in favor of the source country of foreign direct investment. As regards economic convergence and cohesion, respectively, this points to the importance of nurturing ownership-specific advantages of firms by a stimulating domestic policy and market environment in eastern Europe so that FDI flows become a two-way avenue. Also, if eastern European countries have become source countries of FDI themselves the political reservations against FDI inflows are likely to be reduced.
- Given the models' general equilibrium setup, how can transitory unemployment be covered which represents important individual risks and political costs. An answer could be sought along the lines of positive quadratic adjustment costs for workers shifting from declining to expanding sectors where adjustment is time-consuming. Sectoral adjustment costs could be ranked by the divergence in skill-intensities – factor content differentials – of the respective sectors concerned; i.e. if declining sectors are mainly dominated by unskilled workers while expanding sectors have a high share of skilled workers, the adjustment costs will be higher than in the case of skill symmetry between declining and expanding sectors.
- Eastern enlargement could have major real exchange rate effects on the euro-dollar rate. If the euro should appreciate there will be two negative effects for the EU-15 group, namely reduced net exports to the rest of the world and falling net FDI inflows from the US and other third countries. The latter effect is a generalization of an empirical study of Froot/

Stein (1990) which find in a model with imperfect capital markets that normalized US FDI inflows are reduced by a real appreciation of the dollar.

- Depending on the type, scope and speed of the first wave of EU enlargement there could be negative effects on the outsiders in eastern Europe which require the enlarged EU to come up with funds for stabilizing the outsider countries. If trade and investment diversion effects should undermine the expansion of the outsiders – including the countries within the former USSR area – political tensions within Europe and worldwide could grow imposing immediate costs on the EU taxpayer who no longer will benefit easily from a peace dividend.
- Finally, there is the issue of membership in monetary union. If poor accession countries are entering the euro zone too quickly, the result could be economic stagnation, high unemployment and political conflicts in the new member countries.

From a structural adjustment perspective one should highlight the problem of relative price adjustment, exchange rate flexibility and economic catching-up in some detail. In the course of economic development and economic catching-up one can anticipate a change of the real exchange rate and the relative price of nontradables to tradables (price $P^N/P^{T)}$, respectively. The problem is compounded by empirical evidence that price arbitrage for some tradables is rather imperfect even after the reduction of trade barriers in Europe. Richards/Tresman (1996) report that prices of farm products in Latvia reached only about 1/3 of the level in Sweden.

Defining the relative price P^N/P^T as the real exchange rate one will normally witness a rise of this price ratio in the process of rising per capita incomes (Kravis/Lipsey, 1983, 1987; Asea/ Mendozo, 1994). Indeed relative price adjustment is crucial for structural change and economic growth. We will argue that monetary union creates some specific problems for accession countries, i.e. strictly fixed exchange rates would be inappropriate as would be too early monetary union. Defining the price level as $P = (P^N)^\beta (P^T)^{1-\beta}$ and assuming international price arbitrage such that the domestic price of tradables $P^T = eP^T*$ – with ß, e and P^T* representing the share of nontradables in overall consumption, the nominal exchange rate and the world market price level of tradables, respectively – one would face a major problem in a regime combining price stability and fixed exchange rates. Moving towards membership in euro-land indeed is such a regime where we assume that the European central bank achieves price stability. With the accession country pegging its exchange rate to the euro its own monetary policy will have to pursue price stability as well. Since the price level $P=(P^N/P^T)^\beta\ P^T$ the requirements of price stability and international price arbitrage imply a constant relative price of nontradables to tradables. This in turn impairs structural change and growth. An alternative would be periodic appreciations of the currency so that e will fall over time thus bringing about the required fall of the relative price of tradables in the course of economic catching-up.

6. Policy Challenges and Conclusions

In the medium term a first round of an eastern enlargement is feasible provided that structural adjustments in the EU and in the accession countries is accelerated. It is, however, rather doubtful whether a second enlargement round can contribute to stability and prosperity in Europe. Since the two enlargement rounds are inherently intertwined one has to consider all the prospective issues of the second enlargement round already in the first round – otherwise there will conflicts over discrimination as well as a relative increase of the voting power of poor countries in a crucial period of EU constitutional reform. A special problem concerns the psychological imbalance between rising contribution payments of major net contributors and the invisible economic gains for countries such as Austria, Germany, Sweden and Finland which stand to gain from enlargement in form of higher economic growth and rising tax receipts.

Eastern EU enlargements raise more than ever the issue of a Constitutional reform in the Community and of strong changes in EU budget priorities. There is little doubt that continuous political and economic instability in Russia would undermine the prospects for stability and growth in eastern Europe and the accession countries, respectively. Russian outmigration, an internationally expanding Russian mafia and a return to the Cold War – causing massive rises in EU countries' military spending – are three major problems resulting from failure of Russian transformation. These serious aspects should encourage EU countries and accession countries to support the transition process in Russia within a broad and consistent framework which combines technical and financial support with market opening for Russian exports. A crucial issue of enlargement concerns the relative weight of the EU in the global economy. Integrating eastern European countries will enlarge the EU single market and reinforce the global market power of EU companies in the long run. The EU-21 (or EU-26) could thus also become more attractive for US and Japanese foreign investors which already are strongly represented in the EU-15 area. While there are many reasons why foreign investors would favor high income countries in the EU-15 area in the medium term high economic growth in post-socialist accession countries could reinforce the position of eastern Europe as a location of foreign direct investment (FDI) inflows. Relatively low wages, high infrastructure investment and a good education system make eastern Europe a relatively attractive host region provided that not internal political instability or negative spillover effects from Russian instabilities undermine the interest of foreign investor in the region.

A key issue to be raised is whether the EU and euro-land, respectively, will be strengthened in the long term by an eastern enlargement. GDP of euro-11 reached euro 5546 bill., the EU-15 figure will be some euro 7000 in 1999. For comparison the US GDP also will reach nearly euro 7000 bill. in that year. In the long run an eastern EU enlargement by Poland, Hungary, the Czech Republic, Slovenia and Estonia should increase the EU GDP by slightly more than 10%. Exports of the euro-11 group – excluding internal trade – reached euro 757 bill. in 1997 which is more than twice the Japanese figure (370 bill.) and slightly higher than the US figure of 607 bill. A first round of an eastern enlargement could increase the relative weight of EU trade in the long run and thereby reinforce the role of the Community in international organizations. euro-land had foreign exchange reserves equivalent to euro 376,9 bill. in 1997 which was three times the US figure (119.3). In this field the relative position of euro-land will not be improved by an eastern enlargement since foreign exchange reserves – at least those with national central banks – are likely to be reduced in the future in the EU. By contrast, an eastern EU enlargement will raise the employment ratio of the Community as the EU-15 club reached only 58.1% in 1979, while the US reached 72.9%. The traditionally high employment ratios of socialist eastern European countries will nearly be maintained after full transformation so that one may anticipate that enlargement will raise the average EU figure slightly.

The EU's global weight cannot be reinforced if the Community would be characterized by growing internal conflicts – some of which could emerge in the context of high immigration from accession countries which could reach 350 000-600 000 people p.a. for Germany. Such conflicts can only be avoided of economic cohesion and full employment in both eastern and western Europe can be achieved. Therefore market-guided economic convergence is crucial as are reforms of labor markets leading to reduced unemployment figures. It is doubtful that the Community will be able to launch effective and efficient support for economic catching-up of eastern European accession countries with a rigid EU expenditure limit of 1.27%. However, without agreement on a more even financial burden sharing in the EU-15 group it is unlikely that major net contributors (Germany, Netherlands, Austria, Sweden) will accept a rise of the EU budget limit.

After the apparent collapse of the Asian growth model the EU approach to the social market economy looks more attractive than previously. The Asian crisis of the 1990s could reinforce the EU countries' willingness to launch institutional and policy reforms consistent with the need for developing a new pan-European international division of labor and to cope with economic globalization.

The risks of monetary union for accession countries should be carefully considered so that euro membership would be extended only after a successful minimum convergence process in terms of (reduced) per capita income differentials and sustained economic growth. If accession countries should join EMS II one should consider nominal depreciations and appreciations as an unavoidable element of a long-term convergence process. Artificial exchange rate stability should be avoided as much as strong misalignment.

The biggest long-term challenges for a wider EU with 21 or 26 countries is that the ratio of small and poor countries relative to the large countries Germany, France, UK, Italy and Spain will increase dramatically. There is indeed a poor-country problem in an enlarged EU as well as a small country problem of decision-making in the EU policy club such as the European Union.

With respect to a potential majority of poor countries in the EU, the main issue associated with the poor country problem is that with majority voting in the European Council one can anticipate political tendencies which will overemphasize redistribution and the growth of structural funds, respectively – political interference, which comes at high economic opportunity costs, weakens the EU's global economic competitiveness and undermines the prospects for regaining full employment.

With an increasing number of small countries, large countries' power – e.g. measured by the Banzhaf index from game theory (on the small country problem for EU decision-making in the context of an EFTA enlargement see Hosli, 1993) – is falling overproportionately so that there could be both lack of political leadership in an enlarged EU and growing frustration of big countries in the context of majority voting; such countries could even consider leaving the Community. The solution to these serious problems could lie in an EU constitution which would require small countries to form EU internal clubs (e.g. Belgium/Luxembourg, Baltic Countries) where a minimum population figure could be defined for an interior club. This also has to be considered for another reason, namely the inability of very small countries to come up with the necessary administrative resources for assuming the rotating presidency in the EU. It is fairly obvious that such constitutional issues must be solved prior to EU enlargement which poses serious problems of inefficient decision-making within a political club – much along the lines discussed in general terms by Buchanan/Tullock (1962) and Olson (1965, 1982).

A more practical challenge concerns financing of cohesion policies. The range of regions in eastern and western Europe qualifying as objective 1 regions could be reduced by redefining the 3/4 per capita income threshold on the basis of purchasing power standards and by reducing the threshold level to 2/3. Similarly, the cohesion fund (90% threshold for EU member countries) set up for euro candidates could be redefined adequately. Taking into account the principle of subsidiarity, EU competences and interference can be justified only for projects with positive international – EU-wide – external effects so that EU cohesion funds should be allocated to certain environmental projects and infrastructure investments but also to the promotion of a European wide information society. The latter aim would be a new element, but it clearly could be justified on the principle of positive international network effects; moreover, it would be an active element of cohesion since recent analysis has shown empirical evidence that the use of telecommunications and information technology stimulates economic growth significantly (Jungmittag/Welfens, 1998; Antonelli, 1998).

As successful economic catching-up is the key to avoiding excessive growth of EU structural funds, one should not pursue a strategy of rigidly fixing exchange rates of accession countries. EU eastern enlargement will mean even under favorable growth conditions that structural funds will have to increase while the relative share of EU-15 countries on the recipient side will have to fall. If budgetary risks are to be avoided for an enlarged community, the EU-15 group therefore must reform agricultural policies and structural funds in a way which basically reduces funds in favor of the old community. In EU-15 the main recipients on a per capita basis, Ireland, Greece, Portugal and Spain can be expected to be opposed to a rapid eastern European enlargement. EU countries which have much to gain from expanding trade and foreign direct investment in an enlarged community are mainly Finland, Sweden, the Netherlands, Italy and France, but above all Germany and Austria.

In central Europe EU enlargement partly raises complex political questions. The integration situation in German-Polish border areas is much more difficult than in the case of Austria/ Hungary because Germany in general and east Germany in particular were characterized by high rates of structural unemployment in the late 1990s. As xenophobic reactions and reservations against an eastern EU enlargement sometimes can be observed in Austria, it is all the more likely that such problems will be witnessed rather strongly in Germany. Additionally German-Polish and German-Czech relations are compounded by expellees in Germany which claim restitution of their property in formerly German regions of eastern Europe. Unsettled property issues and high, long unemployment in border regions could stimulate political radicalization in part of the enlarged EU – the result being less political cohesion and cooperation in the whole of Europe than prior to enlargement.

Another big political problem concerns a possibly increasing economic divergence between the accession countries and the outsiders in eastern Europe, including Belarus, the Ukraine and Russia (Welfens/Yarrow, 1996; Welfens et al., 1998). From both a political and an economic perspective successful stabilization and growth in Russia are key to long-term stability in Europe. While the Russian government's decisions often have been doubtful with respect to stimulating the transformation process, one should also note that EU enlargement creates large trade diversion effects for Russia's trade. With prospects of 10 CEECs quasi-defecting – which otherwise could be major outlets for a stable Russian market economy – there are poor prospects for Russia's export firms to strongly raise the export volume of industrial goods – unless there would be an EU-Russia free trade zone. This indeed can be recommended as a useful complementary policy option for EU eastern enlargement although one cannot overlook that it creates major long-term adjustment pressures for the wider Community. Finally, it is doubtful that the Community has no attractive alternative to full membership. A modified European Economic Space which e.g. could be defined as a Common Market without direct political representation in Brussels and without free movement of labor would be an interesting option. There are three more interesting problems requiring further analysis in the context of enlargement: (i) The future transatlantic political and economic relations; (ii) Coping with rising environmental problems in Europe (Müller, 1998) where strongly rising trade will cause a massive increase of traffic and emissions respectively; and (iii) Shifts in the relative power of countries and regions, respectively, in international organizations.

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Economic Aspects of the Eastern Enlargement of the European Union

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Summary

Introductory Remarks

The EU intends to enlarge itself eastwards in two stages as of the year 2001, bringing the number of members up to 21 and eventually 26. Any manner of eastern enlargement commencing immediately after full consummation of monetary union will face the EU with a number of adaptation needs. While the eastern enlargement will place an additional financial burden on the EU 15 countries, there is no mistaking the economic advantages of enlargement – at least in the long term. A serious politico-psychological problem posed by the intended enlargement is that the higher budgetary contributions that the major member countries will to have to pay are visible immediately, while the "club benefits" of the enlargement, at least for the existing members, become visible only indirectly. A model simulation performed for Austria, by way of example, shows that the burdens on the national budget and the labour market as a result of the first round of enlargement will be relatively light – indeed, there are even bottom-line benefits to be expected. Much greater problems are likely to be experienced in the second round of enlargement, and, due to the inherent links between the two stages, it would be highly expedient already to take these problems into account in the first round. One particularly important necessity is a reform of the EU constitution, including measures to prevent a relative political preponderance on the part of the smaller EU members. Proposals for a reform of the EU's structural policy and for a re-assessment of its budget priorities are also urgently needed.

Findings

1. An eastern enlargement of the EU creates serious adaptation problems especially for the EU's structural and agricultural policies, because, with the exception of the Czech Republic, the candidates for admission are all relatively poor and have a high proportion of employment in agriculture.
2. A first round of enlargement is likely to have a considerable trade-creating effect and thus promote economic growth. The net welfare effects for Austria are clearly positive, so that similar orders of magnitude can be expected for Germany, too.
3. In the countries on the EU's eastern borders, the differences in per-capita incomes are broader than the average over the candidates for enlargement would suggest, so that allow-

ance must be made for pronounced regional divergences – which could also act as incentives for migration.

4. Eastern enlargement generates considerable need for reform not only of the EU's economic policy. In fact, it gives rise to serious constitutional problems, because enlargement will shift the power balance between wealthy and relatively poor countries on the one hand and between large and small countries on the other. These problems of shifting power balances will become even more severe with the second round of enlargement, so it is important that they should already be taken into account in the lead-up to the first round.
5. After a two-stage enlargement there would be a danger of the EU becoming a community in which more attention is paid to budgetary re-distribution policy, but this is detrimental to growth and could slow down structural change, with adverse effects on the employment situation. Also, widening economic divergence within the enlarged EU could weaken the community's political control and formative capabilities.
6. As regards the EU's structural policy there are relatively simple formulas for reform; the situation is more difficult in the case of agricultural policy. To achieve more growth and employment in the EU it would be expedient to set new budget priorities, especially more expenditure to promote innovation and to stimulate a European information society.
7. Since eastern enlargement would enhance the EU's economic weight, an enlarged community would have to take on more global responsibility. The basis for this could be improved by a reform of the EU's institutions and constitution.
8. The eastern enlargement of the EU would probably indirectly weaken Russia, because it would divert trade away from that country and reduce its growth potential. These effects could be averted by signing a free-trade agreement. Furthermore, it would be worth considering new approaches by the EU in order on the one hand to stabilize Russia and on the other to create new options for Russian participation – below EU membership level – if stability and prosperity are to be assured for all of Europe.
9. Following reforms in economic and wages policy, the EU model of social market economy has every chance of holding its own against the US model in the global contest of systems. In the wake of the Asian crisis, at any rate, prospects have improved for European-style economic systems, with their dual emphasis on efficiency and social harmony, gaining international acceptance as an attractive model.